PBGC
Protecting America's Pensions

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Chairman Mica, Ranking Member Costello, and Members of the Subcommittee: I appreciate the opportunity to discuss the pension challenges facing the U.S. airline industry and the important role played by the federal pension insurance program.

As you know, this hearing is occurring against the backdrop of the largest pension default in the history of the United States. As I will discuss more fully later in my testimony, United Airlines' default on its pension obligations is illustrative of fundamental flaws in the federal pension funding rules—flaws that must be addressed if we are to avoid additional pension tragedies in the future. The United Airlines case also illustrates the inadequacy of the current premium structure to insure pension promises and protect taxpayers against a potential bailout of the defined benefit pension system.

By the numbers, United Airlines' pension plans have assets of roughly $7 billion to cover liabilities of $16.8 billion on a termination basis, for a shortfall of $9.8 billion.[1] The pension insurance program will be responsible for covering $6.6 billion of the shortfall, by far the largest claim in the 31-year history of the PBGC. But the United default also sets another ignominious record—the largest-ever loss of earned pension benefits by workers and retirees. Because weaknesses in the pension funding rules allowed United Airlines to dramatically underfund its pension promises, the company's more than 120,000 plan participants now stand to lose roughly $3.2 billion in retirement income they were counting on.

The U.S. Airline Industry: A History of Pension Defaults

As tragic as these losses are, they are unique only in their size. Indeed, United is merely the latest airline to default on obligations to its workers. In each round of airline bankruptcies, the pension insurance program has wound up responsible for benefits that companies promised but did not adequately fund. In the early 1980s, it was Braniff (1982). In the early 1990s, there were Pan Am (1990) and Eastern (1991). And in the early 2000s, there were TWA (2001) and US Airways' pilots' plan (2003). Claims from just these five airlines total $2.9 billion. As a result, the PBGC is now responsible for paying more than $500 million a year to 80,000 retirees in these failed plans. Overall, these airlines accounted for 12.5 percent of all retirees and 14 percent of claims from failed plans as of September 30, 2004.

When the $2.3 billion claim from US Airways' other (non-pilot) plans and the $6.6 billion claim from United are included, airline claims will more than quadruple from $2.9 to $11.7 billion. As a result, airlines will account for 38 percent of claims from failed plans, vaulting airlines ahead of steel (33 percent). It is important to note that while these airlines will account for 38 percent of all claims, they have paid only 2.6 percent of total premiums in the history of the insurance fund. Beyond United Airlines, there is another $22 billion in unfunded pension liabilities among the legacy carriers.

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[1] The four plans are: the UA Pilot Defined Benefit Plan, which covers 14,100 participants and has $2.8 billion in assets to pay $5.7 billion in promised benefits; the United Airlines Ground Employees Retirement Plan, which covers 36,100 participants and has $1.3 billion in assets to pay $4.0 billion in promised benefits; the UA Flight Attendant Defined Benefit Pension Plan, which covers 28,600 participants and has $1.4 billion in assets to pay $3.3 billion in promised benefits; and the Management, Administrative and Public Contact Defined Benefit Pension Plan, which covers 42,700 participants and has $1.5 billion in assets to pay $3.8 billion in promised benefits.

The Challenge from Low-Cost Carriers and Pensions

There is no question that the legacy airlines are facing unprecedented challenges, both internal and external, as the Government Accountability Office[2] and other experts have attested. The commercial airline industry is capital-intensive, labor-intensive, and has high fixed costs, with revenues and profits closely tied to the nation's business cycle. Among the legacy carriers, these capital and labor costs are higher still; they have a more expensive hub-and-spoke route system, multiple and older fleets, a more senior workforce with defined benefit pensions, and more restrictive work rules. They are also suffering from unprofitable cheap fares largely driven by fierce competition from low-cost airlines, and the entire industry, legacy and non-legacy carriers alike, are suffering from soaring fuel costs. While the first generation of low-cost airlines did not survive, today's low-cost carriers are formidable competitors. In addition, consumers have benefited from the growing use of the internet as a point of sale for airline tickets, which has made it is easy for travelers to choose the lowest-price carrier. Low-cost carriers have increased their share of available seat miles (an industry measure of supply) from 10.8 percent in 1998 to 17.5 percent in 2003.

Congress and the Administration have been sympathetic to the plight of the airline industry. After September 11th, Congress created the Air Transportation Stabilization Board to administer up to $10 billion in loan guarantees to help a struggling industry get back on its feet. These loan guarantees and other types of federal relief were provided to help the airline industry recover from the impact of the terrorist attacks; they were not intended to remedy long-standing structural problems in the industry. Today, nearly four years later and with passenger traffic at record levels, the plea from certain carriers is for a different form of loan guarantee. In economic terms, that is what pension funding rule changes represent —a loan from the pension plan to the company, co-signed by the PBGC and underwritten primarily by financially healthy companies whose premiums finance the insurance program.

Delta and Northwest are seeking funding relief in exchange for freezing their workers' pensions to help prevent these liabilities from growing larger. American has expressed support for a longer amortization period but opposes freezing the pension plan. American's proposal would allow liabilities to grow at the risk that plan assets would fail to keep pace.

[2] U. S. Government Accountability Office, "Commercial Aviation: Legacy Airlines Must Further Reduce Costs to Restore Profitability," GAO-04-836 (August 2004).

Clearly the financial and pension challenges facing each legacy carrier are unique: Two airlines have declared bankruptcy and offloaded their pensions onto the PBGC, several want to freeze their plans in exchange for special treatment, and others intend to fully fund their pension promises.

The airline industry has received substantial relief from its pension funding obligations from Congress. In the Pension Funding Equity Act of 2004 (PFEA)[3], Congress gave airlines a blanket exemption from their pension funding requirements under the Deficit Reduction Contribution (DRC) rules. Under PFEA, airlines and steel companies could elect to defer 80% of their DRC contribution, which is an additional catch-up contribution required for many underfunded plans. This allowed airlines to make little or no contributions for 2004 and 2005.

In 2004, six major airlines elected to receive this funding relief. As a result, these airlines' required pension contributions were about $1.3 billion less than would otherwise have been required. So far in 2005, required contributions for three of these airlines were more than $1.1 billion less than would otherwise have been required.

As Northwest Airlines has disclosed, it obtained additional relief from its pension funding obligations through a $454 million funding waiver granted by the Internal Revenue Service for its 2004 plan year. As a condition of the waiver, Northwest gave the PBGC a lien on certain corporate assets, including slots, routes, aircraft and engines. Other legacy carriers had waiver applications pending when Congress provided essentially the same funding relief in the PFEA. They declined to pursue these waivers after the enactment of PFEA.

This year, US Airways and United both have sought to terminate their ongoing plans. Now that the PFEA relief is about to expire, most of the other legacy airlines are seeking to extend the relief from two years to 25 years.

[3] Pension Funding Equity Act of 2004 (P.L. 108-218, April 10, 2004). This law temporarily replaces the interest rate on 30-year US Treasury bonds with an interest rate based on the average rate of return on high-quality long-term corporate bonds. It also allows airlines to postpone part of their necessary contributions for 2004 and 2005.

The Source and Solution for Pension Underfunding

Pension underfunding is neither an accident nor the result of forces beyond a company's control. On the contrary, it is a largely predictable and controllable byproduct of decisions made by corporate management. In the case of the airlines, a series of decisions allowed pensions to become significantly underfunded. Companies did not contribute as much cash as they could when times were good, and in certain cases contributed no cash at all when it was needed most. In some cases, they granted generous benefit increases that are proving difficult to afford.

The tragedy is not that any of this was the result of illegal activity. The tragedy is that it was the result of perfectly legal activity under our system of flawed pension funding rules and inadequate premium structure. United and US Airways would not have presented claims in excess of $1 billion each—and with funded ratios of less than 50 percent—if the rules worked.

United's pilots' plan provides a case in point. During the period 1997 through 2001, United's debt rating was "BB+", the highest non-investment grade rating. When the company entered bankruptcy in 2002, its credit rating was dropped to "D." From 2000 onward, when the true funded status of each of the company's pension plans was deteriorating, the company**:**

- put no cash into the plan;
- never made a deficit reduction contribution;
- never provided any notices of underfunding to participants; and
- almost never paid a variable rate premium.

United was largely exempt from these rules because it could claim the pilots' plan was "fully funded" on a current liability basis. This rosy picture stands in sharp contrast with what we know to be the true status of United's pilots' plan—an aggregate shortfall of almost $3 billion and a funded ratio of only 50 percent.

United Airlines Pilot Plan

Termination Benefit Liability Funded Ratio 50%
Unfunded Benefit Liabilities $ 2.9 billion

	1998	1999	2000	2001	2002	2003
Current Liability Funded Ratio*	100%	98%	102%	98%	102%	80%
Was the company required to make a deficit reduction contribution?	N	N	N	N	N	N
Was the company obligated to send out a participant notice?	N	N	N	N	N	N
Did the company pay a Variable Rate Premium?	N	N	N	N	N	Y $6.7 million
Actual Contributions	$15.0 million	$40.0 million	$0	$0	$0	$0
Prior Year Credit Balance	$346.2 million	$393.3 million	$496.6 million	$513.1 million	$560.5 million	$525.5 million

* Current Liability Funded Ratio is based on five-year smoothing of assets and smoothed, four-year weighted average interest rate on liabilities.

Similarly, US Airways' pilots' plan was 94 percent funded on a current liability basis, but the plan was only 33 percent funded on a termination basis, with a $2.5 billion shortfall. US Airways was not subject to a deficit reduction contribution for six years leading up to the year of termination and relied on credit balances to avoid making any contributions for the four years immediately before terminating.

US Airways Pilots

Termination Benefit Liability Funded Ratio 33%
Unfunded Benefit Liabilities $2.5 billion

	1996	1997	1998	1999	2000	2001	2002
Current Liability Funded Ratio*	97%	100%	91%	85%	104%	94%	NR
Was the company required to make a deficit reduction contribution?	N	N	N	N	N	N	NR
Was the company obligated to send out a participant notice?	N	N	N	N	N	N	N
Did the company pay a variable rate premium?	$4 million	N	N	N	$2 million	N	N
Actual Contributions	$112.3 million	$0	$45 million	$0	$0	$0	$0

* Current Liability Funded Ratio is based on five-year smoothing of assets and smoothed, four-year weighted average interest rate on liabilities.

Several aspects of the current funding rules contributed to these disaster scenarios, but two should be singled out, as they also were in GAO's recently released report, "Recent Experiences of Large Defined Benefit Plans Illustrate Weaknesses in Funding Rules." [4]

One is the use of so-called credit balances. Just at the point in time when contributions to the plans were needed most, as asset values were falling and liabilities were growing, the company was able to use credit balances built up during the 1990s bull market to avoid putting cash into the plans. Remarkably, notwithstanding the fact that the United pilots' plan is underfunded by almost $3 billion, the company has not made, and has not been required to make, a cash contribution to that plan for the years 2000 through 2004 (and none would have been required until the end of this year).

The other aspect of the funding rules that merits mention is the ability to "smooth" assets and liabilities. Under current law, plans can smooth assets over five years and can smooth liabilities using a four-year weighted average interest rate. Those who want to retain these mechanisms argue that they reduce volatility, but they do not reduce it, they merely mask it—hiding it from the view of workers and retirees.

These issues are not unique to United Airlines, or even to the airline industry as a whole. We saw the same weaknesses lead to the same bad outcomes with the steel industry a few years ago, and there is substantial pension underfunding in other financially challenged industries. The pension insurance program recently has incurred large losses as a result of the pension defaults of companies in the financial services, among other sectors. And, while the program faces additional exposure from the airline sectors, the largest exposure is not from the airline or steel industries, but rather the automotive sector. Of particular concern, several automotive parts suppliers have filed for bankruptcy in recent months. These bankrupt companies sponsor defined benefit plans with more than $800 million in unfunded pension obligations that would become a loss to the pension insurance system should those companies' plans terminate during their bankruptcies.

[4] United States General Accountability Office, "Recent Experiences of Large Defined Benefit Plans Illustrate Weaknesses in Funding Rules," GAO-05-294, p. 22 (May 2005).

Effect of Plan Terminations on Stakeholders

Terminations of chronically underfunded pension plans adversely affect all the stakeholders in the defined benefit system—workers and retirees, companies that have acted responsibly in honoring their pension promises, and potentially U.S. taxpayers. These terminations can have particularly harsh consequences for workers and retirees. While the PBGC steps in to pay benefits to participants in terminated pension plans, because of limits on guarantees established in law by Congress, some workers and retirees may lose benefits they were counting on to provide economic security in retirement. Fortunately, most people receive all of their vested accrued benefits, but that isn't always the case. Expectations of a secure future may be shattered if promised benefits exceed guarantee limits and the plan is underfunded.

For example, workers at United Airlines, in the aggregate, should receive about 80 percent of their accrued benefits. But the United workers and retirees still stand to lose more than $3 billion in promised benefits. Some participants or their survivors may see benefits reduced by half or more because of statutory limits. That is the real tragedy of the current system of flawed funding rules.

Other companies that sponsor defined benefit plans also pay a price through higher premiums. Because the PBGC receives no federal tax dollars and its obligations are not backed by the full faith and credit of the United States, losses suffered by the insurance fund must, under current law, be covered by higher premiums. Not only will healthy companies be subsidizing weak companies with underfunded plans, they may also face the prospect of having to compete against a rival firm that has shifted a significant portion of its ongoing labor costs onto the government. This is clearly at issue in the airline industry. The CEOs of the legacy carriers have publicly stated that this scenario will give United an unfair advantage and may cause them to seek to terminate their pension plans.

In addition to the losses by workers and retirees and other companies that sponsor defined benefit plans, the single-employer insurance program is itself now in jeopardy. With more than $40 billion in assets, PBGC can continue paying benefits for a number of years. But with more than $60 billion in liabilities, PBGC will be unable to meet its long-term commitments without additional revenues beyond those mandated by current law. As a result, taxpayers are at risk of being called upon to bail out the pension insurance program if losses continue to mount.

Administration Reform Proposal

Unless we correct the inadequacies of the current funding rules we are on a course of more losses to all the stakeholders in the pension system. The system is not viable as it stands. On the other hand, with reform, we have a good chance of revitalizing the system.

The Administration has proposed a sensible, balanced reform package to correct the flaws in the system. Core elements include:

- A more accurate measurement of plan liabilities would be used to reflect the financial condition of the sponsor and the risk of plan termination. Two measures of liability—"at-risk liability" and "ongoing liability"—would be employed to require those at greater risk of termination to fund their promises more aggressively.

- Asset and liability smoothing, which distort the true funded status of pension plans, would be eliminated. Credit balances that allow companies to avoid making cash contributions would be barred. Companies that have failed to fund existing pension promises would be limited from making new unfunded promises.

- More accurate and timely plan funding information would be provided to plan participants, investors, and regulators.

- PBGC premiums would be restructured to be more equitable and to generate sufficient revenue to eliminate the $23 billion deficit over time and to pay future expected claims. The flat-rate premium would be increased to reflect wage growth and indexed, and all underfunded plans (based on at-risk or ongoing liability) would pay a variable premium.

Companies that sponsor pension plans have a responsibility to live up to the promises they have made to their workers and retirees. Yet under current law, financially troubled companies have shortchanged their pension promises by nearly $100 billion, putting workers, responsible companies and taxpayers at risk. As United Airlines noted in a recent bankruptcy court filing, "the Company has done everything required by law"[5] to fund its pension plans, which are underfunded by nearly $10 billion.

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[5] Page 26, United Air Lines' Informational Brief Regarding Its Pension Plans, in the US Bankruptcy Court for the Northern District of Illinois, Eastern Division (Sept. 23, 2004).

It is difficult to imagine that healthy companies would want to continue in a retirement system, or that prospective employers would want to become part of a retirement system, in which the sponsor-financed insurance fund is running a substantial deficit. By eliminating unfair exemptions from risk-based premiums and restoring the PBGC to financial health, the Administration's proposal will revitalize the defined benefit system.

Mr. Chairman, the Administration is committed to strengthening the pension insurance program and keeping defined benefit plans as a viable option for employers and employees. This requires a careful balancing of interests and inevitably will require trade-offs among various stakeholder interests. We believe the Administration proposal strikes an appropriate balance and will best protect the pension benefits earned by workers and retirees, minimize the need for future premium increases, and lessen the possibility that taxpayers will have to be called upon to rescue the insurance program.